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April 18, 2006

AGENDA ITEM 4-A

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATIVE COMMITTEE

I. SUBJECT: Assembly Bill 1961 (Richman)—As Introduced
Audit of CalPERS Actuarial Function

II. PROGRAM: Legislation

III. RECOMMENDATION: Oppose

This bill would add unreasonable cost and complexity to the administration of the system by requiring duplicative external audits of questionable value.

IV. ANALYSIS:

This bill would require the Bureau of State Audits (BSA) to conduct and complete an audit of CalPERS actuarial function, on or before December 31, 2007, and every three years thereafter, and to report its findings to the Board of Administration and the Legislature. This bill would require the audit to include nineteen specified elements. The bill would also require the Board to report back to the Legislature on the implementation of any recommendations made as a result of the audit within one year after receiving the report.

Background

Actuarial Office Experience and Credentials

The Actuarial Office is comprised of the Chief Actuary, a managing actuary, three supervising actuaries, and 11 pension actuaries who bring over 315 years of actuarial experience and professionalism to CalPERS. The Chief Actuary alone brings over 25 years of actuarial experience to CalPERS. He has a doctorate degree in mathematics and is a Fellow of the Conference of Consulting Actuaries (FCA), an Associate of the Society of Actuaries (ASA), a Member of the American Academy of Actuaries (MAAA) and an Enrolled Actuary (EA) under the Employee Retirement Income Security Act (ERISA).

The Chief Actuary oversees and directs the CalPERS actuarial staff and external consultants in establishing the liability and contribution requirements for CalPERS-participating employers, including the state, schools, and contracting public agencies. In addition, the Chief Actuary provides independent advice and counsel on actuarial issues to the CalPERS Board of Administration and the Benefit and Program Administration Committee and is responsible for evaluating, developing, and implementing the actuarial policies and procedures of the Board. The Chief Actuary has served in this capacity since 1994. Prior to joining CalPERS, he served as a managing consultant and actuary for William M. Mercer and, prior to joining Mercer, he was the legislative actuary for the state of Louisiana for six years.

Including the Chief Actuary, there are 16 actuaries who have at a minimum a bachelor's degree in mathematics, statistics, or actuarial science and are required to hold the professional designation of Associate of the Society of Actuaries¹. In addition to the Associate designation, most of the CalPERS actuaries also hold the professional designation of an Enrolled Actuaries² or a Fellow of the Society of Actuaries³. To obtain one of these professional designations, the actuary must have successfully completed a rigorous set of testing requirements consisting of several examinations and related course work.

In addition to the 16 actuaries, there are also 25 actuarial assistants with Bachelors degrees in mathematics or a related field, and provide support to the actuaries.

Chief Actuary

CalPERS Chief Actuary has a direct reporting relationship to the CalPERS Board. Very few positions within CalPERS report directly to the Board. This is intended to remove any potential influence on the recommendations provided to the Board. Because of this reporting relationship, the Chief Actuary's annual performance appraisal is conducted by the Performance & Compensation Committee of the CalPERS Board. The Chief Actuary's annual performance plan, which determines the award of performance bonuses, is approved by the Performance & Compensation Committee each year in open session.

Actuarial Office Structure

The Actuarial Office is divided into three functional areas: (1) the Special Projects Team, (2) the Technology Services Team, and (3) the Valuation Services Team. Specifically, the Special Projects Team and Technology Services, together with outside consultants, are primarily responsible for the following:

¹ See Attachment A for a description of the Associate of the Society of Actuaries designation.

² See Attachment A for a description of the Enrolled Actuary designation.

³ See Attachment A for a description of the Fellow designation.

- Performing demographic and economic studies to set actuarial assumptions;
- Reporting to the Board and the Governor on effects of inflation on retirees' benefits;
- Reporting to the Board and the Governor on cost effects of disability retirements;
- Projecting cash flow and liabilities for asset allocation work;
- Recommending to the Board actuarial assumptions and methods to determine the annual contributions;
- Responding to inquiries for information from both internal and external parties including Board members, the Legislature, the Department of Personnel Administration, and the Department of Finance;
- Preparing legislative cost analyses
- Maintaining and enhancing the state of the art Actuarial Valuation System (AVS); and
- Providing support to valuation services team in preparing actuarial valuations.

The Valuation Services Team focuses on performing annual actuarial valuations and cost analysis of plan amendments, for the State, schools, and 1,500 contracting public agency plans. The actuaries on the valuation services team also serve as consultants to the agencies to ensure that the employers understand the retirement costs associated with the respective benefit levels.

The Actuarial Office structure and staffing allows them to not only be efficient, but allows for proper peer review to ensure accuracy. The Actuarial Office also maintains a consulting pool of outside actuaries to assist in performing various special projects when the need arises.

Actuarial Ethical Requirements

The CalPERS actuaries are subject to multiple ethical requirements and strict professional standards of practice. The CalPERS actuaries are required to file an annual Statement of Economic Interests, Form 700, under the Political Reform Act (PRA) and attend ethics training provided by the CalPERS Legal Office. As designated filers in the CalPERS Conflict of Interest code, the CalPERS actuaries are subject to all the conflict of interest laws under the PRA. The PRA requires that the assets and income of public officials which may be materially affected by their official actions are disclosed and in appropriate circumstances the officials disqualify themselves from participating to avoid conflicts of interest.

In addition, actuaries are subject to the Society of Actuaries Code of Professional Conduct and the Actuarial Standards of Practice. The Code and Standards require actuaries to adhere to high standards of conduct, practice, and qualifications of the actuarial profession.

A separate organization called the Actuarial Board for Counseling and Discipline (ABCD) ensures that actuaries adhere to the Code of Professional Conduct and Standards of Practice and takes action in case of violation. The ABCD is an independent entity managed through the American Academy of Actuaries with disciplinary authority for the entire actuarial profession in the United States. The ABCD considers complaints against members of the profession concerning allegations of unethical conduct or unprofessional work products, and may recommend actions ranging from counseling to expulsion.

Audits Already Performed and Required by Law

Annual External Actuarial Audit

By law, CalPERS must secure the services of an enrolled actuary to perform an independent actuarial audit of its system, not less than triennially. While the law only requires triennial audits, the CalPERS Board contracts with EFI Actuaries to perform annual audits of its actuarial function. These independent audits review the actuarial methods and assumptions employed by CalPERS, review the disclosure and presentation of data, and perform parallel valuations of the state, schools, and contracting public agencies.

Comprehensive Annual Financial Report

The Comprehensive Annual Financial Report (CAFR) provides an analysis of CalPERS financial performance for the fiscal year. The CAFR provides a review of the basic financial statements, fiduciary net assets of the funds, changes in assets and liabilities of the CalPERS funds, and the net assets of the proprietary funds of the system. This report is available to the general public and is sent to the Bureau of State Audits, the State Controller, and the Legislature. CalPERS' auditor is required to employ an enrolled actuary for reviewing the actuarial portions of the CAFR.

The most recent CAFR, for fiscal year ending June 30, 2006, was independently audited by Delotte & Touche LLP, and was found to be in conformity with generally accepted accounting principles. In addition, CalPERS has received a Certificate of Achievement for Excellence in Financial Reporting given by the Government Finance Officers Association of the United States and Canada for eight consecutive years.

Annual Audits Performed by the State Controller

Current law requires the State Controller to perform an annual review of each state and local public retirement system, including CalPERS. This annual review is meant to assess the adequacy of funding of each system and to evaluate the triennial valuation. The State Controller also considers certain actuarial assumptions, including the inflation element in salary and wage increases, mortality, service retirement rates, withdrawal rates, disability retirement rates, and rate of

return on total assets. The State Controller is also charged with establishing an advisory committee, including enrolled actuaries, to assist with this annual review.

CalPERS Office of Audit Services

The CalPERS Board also employs an internal auditor with a direct reporting relationship to provide for independence in this function. CalPERS internal auditor conducts independent audits of various CalPERS functions as need indicates and as directed by the Board.

The primary mission of the Office of Audit Services is to increase assurances that CalPERS' assets are safeguarded, that operating efficiency is promoted, and that compliance is maintained with prescribed laws, and Board of Administration and CalPERS management policies. The Office of Audit Services provides, in concert with the external auditor engaged by the Board, an independent appraisal of CalPERS' operations and programs.

Proposed Changes

This bill would require the BSA to conduct and complete an audit of CalPERS on or before December 31, 2007, and every three years thereafter, and to report its findings to the Board of Administration and the Legislature. This bill would require the audit to include the following nineteen elements:

1. Review of CalPERS' code of ethics as it applies to its actuarial operations and review procedures used to monitor compliance with the code of ethics;
2. Determine whether the actuary engages in advocacy activities;
3. Compare actuarial practices to best practices adopted by other pension systems both within California and in other states;
4. Conduct surveys among system employers to determine satisfaction with actuarial services;
5. Review quality and consistency of actuarial processes, including complaint processing and investigation;
6. Determine whether the funding policies have been developed with integrity, objectivity, independence, and without undue political influence. Determine whether changes to funding policies are rational, systematic, and preserve equity between periods. Compare policies to industry averages for reasonableness.
7. Determine whether the actuary considers the reasonableness of each actuarial assumption independently on the basis of its own merits, the degree

of uncertainty in assumptions, the potential for fluctuation, and the consequences of any fluctuations. Compare these assumptions to industry averages for reasonableness;

8. Determine whether systems are in place to ensure that reports generated by the actuary contain information that is relevant, understandable, consistent, comparable, timely, and reliable, and whether the reports are prepared in accordance with generally acceptable governmental accounting policies;
9. Determine whether the actuary adequately considers changes in plan designs or external circumstances that may significantly alter the level and trend of expected future experience when preparing costs analysis of plan amendments;
10. Determine whether actuarial disclaimers were adequate to ensure that readers understood the risks involved and the sensitivity of assumptions;
11. Determine whether data is reviewed adequately for reasonableness, and that systematic overstatements or understatements are likely to be detected;
12. Determine whether employers are properly trained to ensure that payroll data is reported accurately in compliance with pension laws and regulations;
13. Determine whether pension actuarial communications disclose all facts that, if not disclosed, might reasonably be expected to lead to an incomplete understanding of the communication;
14. Determine whether prior actuarial measurements are adjusted, when appropriate, for changes in participant or demographic characteristics, changes in external factors, length of time since prior measurement, and similar changes, when a prior measurement is used lieu of a new detailed measurement for plan amendment cost analyses. Determine whether the actuary projects assets and actuarial liabilities in a consistent manner when the actuary approximates results based on prior measurements;
15. Determine whether contracting local agency employers were provided sufficient information to determine long-term costs of retroactive benefit increases and related risks in order to make informed decisions;
16. Determine whether all reports, including cost analyses of proposed plan amendments, receive peer reviews prior to release to ensure correctness, completeness, and appropriateness of the work product;
17. Compare estimated costs related to proposed plan amendments to actual costs for a representative sample of employers and determine whether risks related to factors causing material differences, if any, were clearly disclosed;

18. Compare the system's actuary department structure to alternative structures and determine whether there are ways to improve the actuary department structure. Review and evaluate methods used to select chief and staff actuaries, methods used to evaluate their performances, and methods used to determine compensation and performance bonuses; and
19. Review any reports prepared by outside consultants related to actuarial operations and determine whether these reports were presented to governing board members.

The bill would also require the Board to report back to the Legislature on the implementation of any recommendations made as a result of the performance audit within one year after receiving the report.

Legislative History

- 1993 Chapter 1169 (AB 348, Cannella) – Amended the law to transfer back to the Board of Administration authority over the CalPERS actuary. *CalPERS' Position: Sponsor*
- 1991 Chapter 83 (AB 702, Frizzelle) - Assigned specific duties to an actuarial consultant firm appointed by the Governor and limited CalPERS' actuarial functions. *CalPERS' Position: Oppose*
- 1989 Chapter 1977 (AB 1284, Quackenbush) - Amended the PERL to allow the Board to contract with a certified public accountant or a public accountant to audit CalPERS' financial statements. *CalPERS' Position: Sponsor*
- 1982 Chapter 77 (AB 1648, Chacon) - Amended the PERL to permit CalPERS to file internally prepared financial reports with the State Controller's Office pending completion of the independent auditor's report. *CalPERS' Position: Sponsor*
- 1980 Chapter 1102 (SB 1647, Garcia) - Required that any differences between any actuarial assumptions and techniques established by CalPERS and those recommended by the actuary which differ significantly be disclosed in the actuary's report and the effect of such differences be shown. *CalPERS' Position: Sponsor*
- 1978 Chapter 388 (SB 1619, Johnson) - Clarified the function of the Controller is to gather the information necessary to compare and evaluate the financial condition of CalPERS; broadened consideration of return on investments to return on total investments; allowed the Controller to specify the contents of the reports; permitted the Controller to waive late penalty upon a showing of good cause. *CalPERS' Position: Sponsor*

- 1972 Chapter 1436 (AB 1490, Joint Legislative Audit Committee) - Enacted provisions to require an annual audit of the State Teachers' Retirement System and Public Employees Retirement System by a certified public accountant or public accountant, who is not in public employment. Provided that audits shall not be duplicated by the Department of Finance or Auditor General and exempted the systems from pro rata general administrative charge for such services. *CalPERS' Position: None*

Issues

1. Arguments by Those in Support

The author argues that CalPERS is the only public employee pension system without independent oversight, and it is only system that relies on staff actuaries to compute pension costs and obligations. In this regard, the author argues that a triennial performance audit of CalPERS' actuarial operations is necessary to confirm CalPERS' commitment to good stewardship and accountability.

2. Arguments by Those in Opposition

There is no known opposition.

3. CalPERS is not the only public employee pension system with internal actuaries.

CalPERS is not the only public employee pension systems with internal actuaries. New York State Teachers' Retirement System, New York Common, and West Virginia Consolidated Public Retirement Board all use internal actuaries. CalPERS' uniqueness and complexity of having to perform over 1,900 separate actuarial valuations each year necessitates the employment of internal actuaries. The use of internal actuaries is also an efficient use of public funds; outsourcing 1,900 valuations would be considerably more expensive.

4. CalPERS is already extensively audited by independent external actuaries and auditors.

CalPERS has been independently audited over 30 times in the last ten years. The CalPERS actuarial valuations are independently audited by an actuarial firm every year, and consistently have been found to be of high quality and attain a high professional standard. EFI's independent audits of CalPERS valuations, experience study, and assumptions have certified CalPERS work as accurate and computed in accordance with generally accepted actuarial principles.

In addition to the actuarial audits, an independent financial audit is performed annually, along with an audit by the State Controller as described above. Each audit is presented in an open forum for review and acceptance by the CalPERS Board of Administration.

5. The BSA has already found CalPERS' actuarial methods to be reasonable and compliant with standards.

In 1994, immediately following the creation of the Bureau of State Audits (BSA), BSA conducted an audit of CalPERS and CalSTRS pursuant to the Budget Act of 1993. The evaluation included a review of economic and non-economic assumptions, actuarial methodology, and other procedures the systems used to develop state retirement contribution rates. BSA also assessed the impact of operating standards and administrative costs on the unfunded liabilities of the system.

In order to carry out this audit, BSA contracted with the consulting firm Buck Consultants, an actuarial services consultant, to assist the BSA in reviewing CalPERS' June 30, 1992 valuation. Buck Consultants concluded that the methods used to determine the costs and funding are common among public retirement systems throughout the United States. Buck also concluded that the assumptions, methods, and estimates used regarding unfunded liabilities were reasonable and in accordance with generally accepted actuarial practice.

BSA would likely need to retain the assistance of an outside consultant to conduct future actuarial audits of CalPERS.

6. Adoption of Actuarial Assumptions and Methods

As noted above, actuarial assumptions and methods are thoroughly audited once adopted. It is also important to note that extensive review is conducted prior to the adoption of any new or revised assumptions. Actuarial assumptions and methods are recommended to the CalPERS Board by its Chief Actuary and are adopted by the Board in open public session. Significant changes require two public Board hearings, for both a first and second reading. Interested employers are notified of Board action after both readings and have the opportunity to provide feedback to the Board.

Significant changes to actuarial assumptions and methods are also developed based on a thorough process that incorporates external review prior to adoption. For example, CalPERS' economic assumptions were developed by an external consulting actuary and were reviewed by CalPERS external auditing actuary prior to adoption. CalPERS' demographic assumptions were based on an experience study that was subject to an external audit that was presented to the CalPERS Board prior to adoption. In addition, recent changes to CalPERS' asset smoothing methodology were vetted with participating employers through numerous forums conducted over a 6-month period. A workshop provided to the Board on the methodology was videotaped and available on the CalPERS website during this period. Input from employers and the public, including input

gathered from a special employer survey, were incorporated in the policies adopted by the Board.

7. CalPERS takes a number of steps to ensure quality and integrity of data.

Data provided by participating employers provide the foundation for an actuarial valuation. CalPERS strives to ensure that the data is sufficient and reliable for the purposes of an actuarial valuation. The following briefly describes CalPERS steps to validate primary data sources.

Global Data Checking

CalPERS' actuarial assistants perform global data checking on the entire member database by generating error reports during the data extract process. Error reports are researched and data fixes are compiled and corrected. Year-to-year comparisons of load statistics are analyzed and all questionable findings are researched. This process is conducted in accordance with rules established by the Chief Actuary, including several queries designed to find outlier data.

Membership Data and Individual Plan Information

Once the global data checks are complete, the actuarial assistants perform additional data checks on all the individual and pooled plans. CalPERS' actuarial assistants spend over 10,000 hours annually checking and validating over one million membership data records and plan information.

CalPERS has also developed numerous tools for their actuarial assistants to use in checking, validating and correcting data. One tool focuses on reconciling participant data counts from the prior year to the current year. This allows staff to validate the reasons for member status changes. Another tool provides reconciliation of plan assets. Special data error reports are also generated to find member data that falls outside of programmed safeguards to ensure the integrity of the data. Potential errors are researched and corrected if necessary. Another program looks at plan statistics, identifying trends within a rate plan, such as large salary increases or a large number of members buying back service. Additional tools are utilized to evaluate gains and losses by plan, valuation changes resulting from new benefits granted, and the results of other changes in plan provisions.

Payroll Edits

As part of its automated employer reporting system, CalPERS has instituted data edits designed to validate the records contained in the employer's payroll file for accuracy. Invalid records identified by the system can be corrected on-line by employers utilizing the automated system. Payroll edits help identify

errors immediately and promote accurate and timely reporting of employer payroll data.

Employer Audits

The CalPERS Office of Audit Services performs audits of participating employers, including review of payroll reporting and membership enrollment issues. In 2006, the Office of Audit Services will conduct 65 audits including state and CSU employers. Employer audits were established to help ensure that public agencies contracting with CalPERS comply with the Public Employees' Retirement Law and accurately report all member earnings and contributions to CalPERS.

Training & Education for Employers

CalPERS provides all contracting employers with instructor led training on how to correctly report payroll data to CalPERS in accordance with current pension laws and regulations. Training workshops are regularly held throughout California. If employers want additional assistance with their payroll reporting, CalPERS provides special one-on-one payroll training to address the specific needs of the employer.

8. Reviewing Code of Ethics is Unnecessary

Like other public officials, the CalPERS actuaries are subject to the conflict of interest laws under the Political Reform Act. The conflict of interest laws are designed to prevent a public official from using his or her official position to influence or attempt to influence a governmental decision. Requiring an audit to review the code of ethics and the advocacy activities of the actuaries is unnecessary as the PRA's disclosure and conflict of interest rules is California's forum for ensuring that CalPERS actuaries are not acting in self interest.

Like other professional occupations, actuaries are also subject to a professional code of ethics. The Society of Actuaries Code of Professional Conduct monitors compliance with these professional standards, as noted above.

9. Employer Surveys

CalPERS regularly surveys its participating employers. In 2004, CalPERS hired the consulting firm, Michael Strategic Analysis, to conduct a survey of 400 randomly selected employers to measure the knowledge, attitudes and practices of eleven types of services offered by CalPERS, including the actuarial function. The overall satisfaction expressed by CalPERS' employer-customers was high or very high. With respect to the actuarial function, the surveyor concluded that there were no items revealed that would appear to warrant corrective action by CalPERS.

10. Legislative Policy Standards

The Board's Legislative Policy Standards indicate an oppose position on proposals which add unreasonable cost or complexity for the administration of the system. AB 1961 requires the Bureau of State Audits to conduct an external audit of CalPERS actuarial function every three years, which will lead to additional administrative expenditures for the performance of duplicative audits of questionable value.

VI. RESULTS/COSTS:

Program Costs

There will be additional costs to the state to conduct the audit required by this bill. Based on previous audits conducted by the BSA, CalPERS estimates that the audit required by AB 1961 would cost approximately \$300,000 every three years.

Administrative Cost

CalPERS would incur additional administrative costs and expenditure of staff time in order to provide the resources required by the BSA or the external auditor hired by the BSA. CalPERS' administrative costs are borne by the employers participating in the system.

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Chief Actuary
Actuarial and Employer Services

Attachment A

Associate of the Society of Actuaries

To obtain an Associateship in the Society of Actuaries, a candidate must complete:

1. The preliminary education component consisting of four examinations in: Probability; Financial Mathematics; Actuarial Models; and Construction and Evaluation of Actuarial Models;
2. The Validation by Educational Experience requirement for the following subjects: Economics; Corporate Finance; and Applied Statistics;
3. Eight Fundamental of Actuarial Practice (FAP) Modules to expose candidates to practical problem solving used in the actuarial profession, including passage of two examinations following completion of modules; and the Associateship Professionalism Course (APC), which covers professionalism, ethics and legal liability and makes extensive use of the case study method.

Enrolled Actuaries:

To become an Enrolled Actuary (EA) a candidate must complete:

1. The EA-1 examination covering the mathematics of (1) compound interest and practical financial analysis, and (2) life contingencies and practical demographic analysis;
2. The EA-2A examination covering the selection of actuarial assumptions and the calculation of minimum required and maximum tax-deductible contributions under current pension law, along with the related actuarial mathematics; and
3. The EA-2B examination covering relevant pension laws, in particular the provisions of ERISA and related laws, regulations, and rulings as they affect pension actuarial practices.

Fellow of the Society of Actuaries:

After completing all of the Associateship requirements, to earn the Fellowship designation, the candidate must complete:

1. A course in Applied Actuarial Modeling, with an emphasis in the modeling process, business problem solving, and communication;
2. A course in Advanced Specialized Actuarial Practice examinations, including Finance and Enterprise Risk Management, Health, Group Life & Managed Care, Individual Insurance, Investments, and Retirement Benefits;
3. The Professional Development (PD) requirement, which focuses on the technical, legal, ethical, cultural, professional and practical parameters that apply to the chosen practice area; and
4. The Fellowship Admission Course (FAC) to increase awareness of professional ethical issues and identify strategies to address them, as well as encouraging actuaries to approach problem solving from varied directions and perspectives.